theirview

Union budget: not as expansionary as it seems

Big announcements notwithstanding, the fine print suggests that fiscal deficit targets are likely to be met

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The Union budget has raised concerns about macroeconomic stability, as reflected in some key budget announcements. An examination of the fine print suggests that while there may be some upside risks to inflation, fiscal deficit targets look likely to be met.

First, the full cost of the health protection scheme that promises Rs5 lakh per household per year appears to be more than what has been budgeted. Second, oil prices may rise while budget estimates seem to assume a scenario of benign oil prices and this may have fiscal implications. Third, the government has announced a 50% increase in minimum support prices (MSP) for the coming kharif crop that could lead to a higher deficit. In addition, the corporate tax rate for small enterprises has been cut to 25%.

On the first count, rolling out an all-India health insurance scheme is a challenging task. State capacity to deliver is limited. From the private sector side, good quality tertiary healthcare is still not available all across the country as would be required for this scheme. The supply response of the private sector to the incentives created by this scheme may take some time to realize.

In addition, regulatory capacity of, one, the health sector to regulate the private providers, and, two, the health insurance sector to make sure fraud does not become rampant will take time to develop.

Further, states need to come on board as well for this scheme. Many of them already have their own insurance schemes and will need to replace old schemes. The transition from old to new schemes may require time. This may mean that the new scheme will have limited expenditure in the current year. The allocation of only Rs2,000 crore suggests that this may indeed be the expectation of the government as well. This may mean that the impact on the deficit of the health insurance scheme may be limited.

Oil prices have been rising in recent days. This could put an upward pressure on fuel prices. When global oil prices were falling, the decline in price was not passed on to the consumer as the government increased excise duties. It remains to be seen whether the government will try to keep the price of oil stable. If oil prices rise, would excise be cut to cushion the consumer from the price rise? If so, how would this impact excise collections?

Further, the impact of the oil price hike on fertilizer subsidy will be another issue to contend with. The oil price hike would also mean a larger import bill and a higher current account deficit. This could possibly put downward pressure on the rupee.

In the past, it has been seen that increase in MSP has led to food inflation. Another channel through which the impact of the MSP hike could be inflationary is through a larger fiscal deficit. There are two possible models through which higher MSP is paid to farmers. One is via actual procurement of foodgrains by the Food Corporation of India (FCI) from farmers, which pays MSP to farmers.

However, given that the capacity of FCI to procure all the foodgrains listed across the country is limited, the alternative is to directly pay farmers the difference between market price and MSP. Anecdotal evidence suggests that the scheme benefits traders. In places where this scheme has been tried, it has been found that the difference goes to a large extent into the hands of traders who pay farmers low prices and collude with them to pass on the additional payment to them.

This could mean a big payout by the government but not an equal increase in the income of farmers. If "leakage" arising from this flaw in the scheme could be limited, the deficit could remain under control.

In the budget speech of March 2015, the finance minister had promised to bring down the corporate tax rate to 25% over a period of four years. This promise was made on the grounds that the regime of corporate taxes in India needed to be rationalized, exemptions to be removed, and tax rates to be brought down to globally competitive levels. By the end of four years, the corporate tax rate has been cut only for smaller enterprises, which account for roughly less than 10% of corporate tax payments. The remaining corporates will still pay higher taxes.

One reason for not going ahead with the reform has been the difficulties in removing exemptions. If the finance minister had gone ahead with reducing the corporate tax rate for all enterprises without removing exemptions, collections would have suffered. While it is a pity that the reform has not been attempted, the effect of the rate cut on the deficit would be limited since only a small share of tax collections will be affected.

One clear impact of the budget will be higher personal income tax collections on account of the long-term capital gains tax, dividend distribution tax for mutual funds and the increase in education cess. As the GST (goods and services tax) regime is simplified, we may also see a pickup in GST collections.

What does all this mean for inflationary expectations and monetary policy?

Over the past one year, the monetary policy committee (MPC) has repeatedly raised concerns about the fiscal deficit. Whenever rates have not been cut despite inflation being around or even below the target of 4%, the MPC has pointed to fiscal slippages and possible higher borrowing due to the Seventh Pay Commission, and higher house rent allowance. Though the MPC may have concerns about the fiscal deficit, if the limited capacity of the government's delivery mechanisms is taken into account, the MPC should not be overly concerned. This can create space for an accommodative stance of monetary policy.

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